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# Supreme Court of the United States

OCTOBER TERM, 1945.

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CHARLES ELMORE CROPLEY

## No. 361

**BURTON-SUTTON OIL COMPANY, INCORPORATED,**
**Petitioner,**

**versus**

**COMMISSIONER OF INTERNAL REVENUE.**

**On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.**

## BRIEF FOR THE PETITIONER.

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IN THE
SUPREME COURT OF THE UNITED STATES

October Term, 1945.

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On Writ of Certiorari to the United States Circuit Court of Appeals for the Fifth Circuit.

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# BRIEF FOR THE PETITIONER.

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## OPINIONS BELOW.

The opinion of the Tax Court (R. 42-54) is reported at 3 T. C. 1187. The opinion of the Circuit Court of Appeals (R. 66, 67) is reported at 150 F. 2d 621.

## JURISDICTION.

The judgment of the Circuit Court of Appeals was entered on July 6, 1945 (R. 76). The petition for a writ of certiorari was filed on August 23, 1945 and was granted on February 11, 1946 (R. 78). The jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

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## QUESTION PRESENTED.

The question is whether the Tax Court and the Circuit Court of Appeals erred in holding that the taxpayer could not exclude or otherwise deduct from its taxable income payments made to its transferor's assignor, such payments being a share of the net income derived from the extraction and sale of oil.

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## STATUTE INVOLVED.

The relevant provisions of the statute involved are set forth in the Appendix, *infra*, p. 28.

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## STATEMENT.

This case involves income and excess profits taxes for fiscal years ended in 1936, 1937 and 1938. The facts on the issue before the Court were stipulated by the parties

(R. 34-39, 41) and were found by the Tax Court as stipulated (R. 44-47, 51).

On or about February 27, 1933, taxpayer acquired from J. G. Sutton a contract which had been entered into between the Gulf Refining Company of Louisiana and J. G. Sutton on February 18, 1933 (R. 35). The contract recited:

> "That, Gulf Refining Company of Louisiana, hereinafter styled 'Grantor', for and in consideration of Ten Dollars ($10.00) and other valuable considerations to it in hand paid by J. G. Sutton, receipt of which is hereby acknowledged, has sold, conveyed and transferred, and does, hereby sell, convey and transfer unto the said J. G. Sutton, hereinafter styled 'Grantee', all oil and gas rights, titles, interests or privileges given, conveyed and transferred by virtue of that certain mineral lease executed by Cameron Parish School Board to S. W. Sweeney, dated April 4, 1927, covering all of the whole of section Sixteen (16), Township Fourteen (14) South, Range Thirteen (13) West, Louisiana Meridian, in Cameron Parish, Louisiana.
>
> "This assignment is made subject to the following terms and conditions:
>
> "1. Grantee binds and obligates himself to begin on or before thirty days from date, operations for the drilling of a well on said land and to continue his operations thereon with reasonable diligence to completion or abandonment in an honest, bona fide effort to find oil or gas in paying quantities on said land. After the completion of said well, Grantee shall continue such operations on said land as may be necessary to continue said lease in full force and effect. If, after completing said well, Grantee shall desire to

cease operations on said land, he shall, upon demand reassign said lease to Grantor not less than thirty days prior to the maturity date of any obligation accruing after the date of the cessation of his operations of said land. (R. 35, 36.)

* * * * *

"After Grantee has met the underlying and overriding royalty obligations referred to in paragraph hereof and has been reimbursed out of the proceeds of the oil and gas produced from all such costs and expenses of operating upon said property as defined below, Grantee shall account to and pay Grantor 50% of the remaining portion of said proceeds of the oil and/or gas produced and sold from the said land * * *" (R. 36.)

The contract further stipulates how "accounting and settlement under this agreement shall be made" monthly (R. 36); for "the cost and expenses allowed in this agreement" (R. 37, 38); for keeping accurate records accessible for inspection and furnishing statements (R. 38); for Gulf's entry upon the land to produce sulphur (R. 38); and for an option in Gulf to purchase all oil "during the life of this agreement" (R. 39).

Shortly after acquisition taxpayer, pursuant to terms of the above contract, proceeded to the development and operation of the property and obtained oil and gas in paying quantities. In accordance with the provisions of paragraph 3 of the contract, the following sums were paid to the Gulf Refining Company of Louisiana during the taxable years indicated:

| | |
|---|---|
| 1936 | $ 17,406.19 |
| 1937 | 232,498.94 |
| 1938 | 286,128.28 |

The foregoing amounts were claimed as deductions in the returns filed for the respective years. Respondent in his notice of deficiency has disallowed said deduction on the ground that the amounts paid to Gulf Refining Company represent additional cost of the property covered by the contract, recoverable through depletion allowances. Depending upon the Board's final decision the allowable depletion will be determined under Rule 50. (R. 50.)

The Tax Court sustained the Commissioner (R. 54) and the Circuit Court of Appeals affirmed. (R. 67.)

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## SUMMARY OF ARGUMENT

Through the provision for net profit payments the assignor retained an economic interest in the property and its share of the net profits was its own gross income from the property rather than the proceeds from the sale of a capital asset. Accordingly, the petitioner is not entitled to a statutory allowance for depletion with respect to the assignor's share of the income from the property nor is such share taxable as gross income of the petitioner.

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## ARGUMENT

The taxpayer petitioner in this case is required to pay underlying and overriding oil royalties to the lessor and lessee of the original lease and also 50% of the net income derived from oil production to its transferor, assignor

Gulf Refining Company, hereinafter called Gulf. The question involved is whether the taxpayer is entitled to exclude Gulf's share of the profits from its taxable income as not being gross income of the taxpayer under Section 22(a) of the Revenue Acts of 1934 and 1936, or otherwise deduct these profit payments as rentals paid under Section 23(a) of the Revenue Acts of 1934 and 1936. There is no dispute concerning the taxpayer's right to exclude the gross royalties from its taxable income. The only issue is whether the taxpayer is also entitled to exclude or deduct the payments made to Gulf under Gulf's stipulation for one-half of all of the net profits derived from the oil production.

Prior to the execution of the instrument involved here Gulf owned the entire capital investment in the oil in place with the exception of the lessor's underlying royalty and an outstanding overriding royalty; it alone, as the owner of the original lease, had the exclusive privilege of exploring the land and extracting all underlying minerals. Gulf granted this exclusive privilege in respect of the oil and gas only to the taxpayer's transferor on conditions which included the assumption of definite drilling and development obligations on the part of the assignee and the stipulation that it (Gulf) should receive 50% of all of the net income derived from the extraction of the oil in place.

The Tax Court and the court below held that the taxpayer could not deduct or exclude from its taxable income the net profit payments made by it to Gulf. The decisions below, of necessity, also determine that Gulf had made

an absolute sale of the property and that it does not receive gross income from the property, from which it also follows that Gulf may not deduct the allowance for depletion with respect to the net profit payments received from the taxpayer.

It is taxpayer's position that under Section 114(b)(3), construed in conjunction with Section 23(m) which provides for an allowance for depletion according to the peculiar conditions of each case and for an equitable apportionment between the lessor and lessee, and under the decisions of this Court that Gulf has gross income from the property by the reason of its provision for net profit payments upon which it alone is entitled to the allowance for depletion; that accordingly, Gulf's portion of the gross income from the property is not a part of the taxpayer's gross income as defined in Section 22(a), or such payments are otherwise deductible from gross income as rentals paid for the privilege of extraction under Section 23(a).

Where a taxpayer has a capital investment in only a portion of the mineral deposits, he is not entitled to depletion beyond the extent of interest; he may claim only the allowance with respect to "the gross income from the property" which he has "the right to retain". *Helvering v. Twin Bell Oil Syndicate*, 293 U. S. 312, 321. Likewise, only the income upon which he may claim the allowance for depletion is included in his taxable gross income. *Thomas v. Perkins*, 301 U. S. 655, 663. Thus, the same basic considerations which establish who is entitled to depletion likewise determine to whom the gross income

from the property is taxable. "That issue is, who has a capital investment in the oil and gas in place and what is the extent of his interest." *Anderson v. Helvering*, 310 U. S. 404, 407.

In ascertaining who has a capital investment and the extent thereof, technical title to the oil in place is not important. *Burnet v. Harmel*, 287 U. S. 103; *Palmer v. Bender*, 287 U. S. 551; *Kirby Petroleum Company v. Commissioner*,[1] No. 56, this Term, decided January 28, 1946, 90 Law ed. Adv. Ops. 293; also see *Lynch v. Allworth-Stephens*, 267 U. S. 364. Nor is an interest to be determined from the form of the particular instrument involved or from the formalities of the kind of conveyance made; instead, it is the "practical consequences of the provision for payments" which are decisive. *Anderson v. Helvering*, 310 U. S. 404, 411. Thus, in *Thomas v. Perkins*, 301 U. S. 655, 659, where the granting clause in the assignment would have been sufficient, if standing alone, to transfer all of the oil to the assignee, the instrument was found to be qualified by other parts which unmistakably showed an intention to withhold from the operation of the grant an interest in the oil for the assignor. And earlier, in *Palmer v. Bender*, 287 U. S. 551, where the instrument was in the form of a sale reciting that the partnership "does sell, assign, set over, and transfer . . . unto the Ohio Oil Company", it was stated:

> "It will be observed that the statute directs that reasonable allowance for depletion be made as a deduction in computing net taxable income, 'in the case of oil and gas wells, . . . according to the peculiar

[1] The page references hereinafter made to the *Kirby* case are those of 90 Law ed. Adv. Ops.

conditions in each case . . . The allowance to the taxpayer is not restricted by the words of the statute to cases of any particular class or to any special form of legal interest in the oil well . . . . The concluding sentence of the section that 'In the case of leases the deductions allowed by this paragraph shall be equitably apportioned between the lessor and the lessee' presupposes that the deductions may be allowed in other cases. The language of the statute is broad enough to provide, at least, for every case in which the taxpayer has acquired, by investment, any interest in the oil in place, and secures, by any form of legal relationship, income derived from the extraction of the oil, to which he must look for a return of his capital. (pp. 556-557.)

". . . whether they became technical sublessors or not, they retained, by their stipulations for royalties, an economic interest in the oil in place, identical with that of a lessor." (p. 558.)

Accordingly, the technical title to the oil in place, the form of the contract, and the legal relationship of the parties are all quite immaterial: it is enough for a taxpayer to have an "economic interest" and "By this is meant only that under his contract he must look to the oil in place as the source of the return of his capital investment, which is necessarily reduced as the oil is extracted" and ". . . does not mean title to the oil in place but the possibility of profit from that economic interest dependent solely upon the extraction and sale of the oil" *Kirby Petroleum Company v. Commissioner, supra*, (p. 296).

The *Kirby* decision made a concrete application of these principles to provisions for net profit payments received by lessors and, in holding that such payments were subject to depletion, stated:

> "If the additional payment in these leases had been a portion of the gross receipts from the sale of the oil extracted by the lessees instead of a portion of the net profits, there would have been no doubt as to the economic interest of the lessors in such oil. This would be an oil royalty. *The lessors' economic interest in the oil is no less when their right is to share a net profit.* As in *Thomas v. Perkins*, 301 U. S. 655, *their only source of payment is from the net profit which the oil produces. In both situations the lessors' possibility of return depends upon oil extraction and ends with the exhaustion of the supply.* (p. 296.) (Italics suppied.)
>
> "*If* we assume that *the only payment* for the privilege of oil extraction *made* to the taxpayer lessors by the lessees *was the portion of 'net income'* paid under the leases, *it would be clear that such payment* of 'net income' *would taxwise be rent or royalty* paid by the lessees for the privilege of extraction. Since *Section 114(b)(3) would require the lessees to deduct this rent* or royalty from their gross incomes from the sale of oil from the property *before taking the lessees' depletion*, a gross receipt from oil sold, equal to the amount of the 'net income' paid to the taxpayer lessors, would not be subject to depletion, unless the taxpayer lessors are permitted to apply depletion to this payment. This would be contrary to the purpose of the depletion statute, which is to allow to the lessor and lessee together a depletion of 27½ per cent of the gross sale price of the oil. On the other hand, if depletion on the 'net income' pay-

ments is allowed to the lessors, the lessees are allowed depletion on the gross income from oil sales less the net income payment and the entire allowable depletion is allocated between the lessors and lessees." (p. 297.) (Italics supplied.)

The decision of necessity also determined that the lessees who made the profit payments were not required to include the portion of profits paid in their taxable income. (See *supra*, p. 7.)

A necessary corollary to the principle of economic interest is the rule that the statutory words "gross income from the property" governing the allowance for depletion, means gross income received from the operation of oil and gas wells by one who has a capital investment therein—not income from the sale of the oil and gas properties themselves. *Anderson v. Helvering*, 310 U. S. 404, 408, 410. "By an outright sale of his interest for cash, such an owner converts the form of his capital investment, severs his connection with the production of oil and gas and the income derived from production, and thus renders inapplicable to his situation the reasons for the depletion allowance." *Anderson v. Helvering, supra* (p 408). Thus, where there is a cash payment which does not depend upon production it is necessary to determine whether the transaction is essentially a lease or a sale in order to give character to such cash as ordinary income or as proceeds from the sale of a capital asset. (See also *infra* pages 18-20.) The instant case does not involve a cash payment which is made without regard to the extraction and sale of the oil in place or whether Gulf would have been entitled to depletion upon such a cash payment if it had

received such a payment; the only issue is concerned with whether Gulf receives gross income from the property by reason of payments which do depend solely upon the extraction and sale of the oil in place. It is our opinion that the possession of the right to receive payments which depend solely upon the production and sale of the oil in place to which Gulf must look for the return of its capital investment is of and in itself an economic interest; that, accordingly, there is no need to look to the instrument to determine whether it is a lease or a sale. Nevertheless, it can be readily seen that, if Gulf had received a cash bonus for the execution of the instrument here involved, such a cash payment would have been ordinary income; the deal was essentially a sublease and not a sale.

"If it is found that some of the principal relations, such as the duty to pay royalties, the duty to drill wells and develop and operate the premises, which make up the legal interest of the lessee of a lease for oil and gas purposes, have been expressly created, it is safe to assume that the intention was to create a leasehold interest, and not a separate estate in fee." Summers Oil and Gas, Permanent Edition, Vol. 1, p. 320, par. 132. The most essential difference between a lease and an absolute sale "is the fact that the predominating purpose of a lease is to secure the exploitation and development of the property". *Danciger Oil and Refining Company v. Powell*, 154 S. W. (2d) 632, 137 A. L. R. 408, 413; cited with approval in Westley W. West 3, T. C. 431, 453, affirmed in 150 F. 2d 723. To recover his capital investment, the lessor expects this development to yield payments which "do not normally become payable as the result of a single trans-

action within the taxable year, as in the case of a sale of the property". *Burnet v. Harmel*, 287 U. S. 103, 106; *infra*, p. 25. Since the lessee merely shares the profit derived from the land, he does not buy an interest from the lessor; "Instead, the lessee acquires an interest by assuming the obligation to develop and operate the property". *G. C. M. 22739, C. B. 1941-1*, pp. 214, 217. Cf. *Helvering v. Elbe Oil Land Development Company*, 303 U. S. 372, *infra*, pp. 16-21.

The instrument involved in the instant case carries the provision for Gulf to receive payments out of production, which is a lessor's ultimate object in making a lease; it imposes a definite obligation to drill and develop and operate the leasehold premises which are the principal duties of a lessee. It is enough that Gulf has a right to payments identical with those of a lessor. *Palmer v. Bender, supra.* The Gulf contract, however, goes even further than *Palmer v. Bender* in that it imposes definite and affirmative duties upon the assignee which are identical with those of a lessee. It follows that Gulf did not sell the whole or any part of the interest in the original lease; instead, the taxpayer acquired an interest in the underlying minerals by assuming the obligations to drill an exploratory well and to further develop the property.

The reasoning of the *Kirby* decision and the conclusions reached there (p. 296) are particularly applicable here. If Gulf had stipulated for an overriding royalty out of gross production (or for an oil payment) instead of a portion of the net profits, there would have been no doubt as to its economic interest in such oil.[2] Its economic

[2] *Palmer v. Bender*, 287 U. S. 551 (overriding royalty); see *supra*, p. 8; *Thomas v. Perkins*, 301 U. S. 655 (oil payment).

interest is no less when its right is to share a net profit. Its only source of payment is from the net profit which the oil produces. In both situations, Gulf's possibility of return depends upon oil extraction and ends with the exhaustion of the supply.

Accordingly, whether Gulf became a technical sublessor or not, it retained, by its stipulation for net profit payments, an economic interest identical with that of a lessor.[3] It follows that Gulf did not sever its connection with the underlying oil and the income therefrom, but retained a continuing interest therein; the funds received by it do not constitute proceeds from the sale of a capital asset, but are Gulf's ordinary gross income from the property.[4] These payments, therefore, are to be excluded or are to be otherwise deducted from the taxpayer's gross income as rent or royalty paid for the privilege of extraction.[6]

The Commissioner, in determining that the taxpayer could not exclude the profit payments, was merely following the opinion consistently applied by his office since *G. C. M. 22730*, 1941-1 C. B. 214, 222, which is to the effect that the right to share the net profits derived from the operation of oil wells does not, in any event, represent a depletable economic right. Likewise, the Fifth Circuit Court of Appeals, in affirming the decision of the Tax Court, was following the same rule consistently used by

[3] *Palmer v. Bender*, 287 U. S. 551; 558, *supra* pp. 8 and 9.
[4] *Cf. Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372; *infra*, pp. 16-21. Also see *West v. Commissioner*, 150 F. 2d 723.
[5] *Anderson v. Helvering*, 310 U. S. 404, 410; *Thomas v. Perkins*, 301 U. S. 655, 663, *supra*, p. 8.
[6] *Kirby Petroleum Company v. Commissioner*, *supra*, p. 10.

that Court in all cases involving such rights.[6a] On the other hand, the Ninth Circuit Court of Appeals has always held that net profit payments do represent a depletable interest.[6b] The Tax Court, however, has put the cases on one side or the other depending upon whether the recipient also possesses either technical title, an additional payment payable out of gross production, or the surface of the land. The Tax Court's adverse decision in the instant case (R. . . . . ; 3 T. C. 1187) was put squarely upon the authority of *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588 (C. C. A.-5) affirming 44 B. T. A. 624, which, before the Board of Tax Appeals, rested principally upon *Helvering v. O'Donnell*, 303 U. S. 370, *Helvering v. Elbe Oil Land Development Co.*, 303 U. S. 372, and *Marrs McLean v. Commissioner*, 41 B. T. A. 565.

In the *O'Donnell* case the taxpayer receiving the net profit payments was a stranger to the lease; under his contract he was entitled to money equivalent to a proportion of the net profits as the consideration received for the sale of his stock in the corporation which was the owner and operator of the lease. The decision (p. 371) stated that "as mere owner of the shares in the San Gabriel Company, respondent had no such economic interest". Similar cases are rarely encountered because the holder of the net profit right usually, as in the instant case, had a capital investment in the oil in place prior to the execution of the instrument.

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[6a] *Blankenship v. U. S.*, 95 F. 2d 507; *Quintana Petroleum Co. v. Commissioner*, 143 F. 2d 588; *Commissioner v. Kirby Petroleum Co.*, 148 F. 2d 80, reversed by Sp. Ct. January 28, 1946.

[6b] *Holly Development Co. v. Commissioner*, 93 F. 2d 146; *Commissioner v. Felix Oil Company*, 144 F. 2d 276; *Commissioner v. Anna Vickers Crawford*, 148 F. 2d 776, affirmed by Sp. Ct., in *Kirby* decision of January 28, 1946.

In the second case, the *Elbe Company* owned certain oil and gas prospecting permits, drilling agreements, leases, and equipment. The properties were producing oil in commercial quantities. On October 3, 1927, the company entered into a contract with Honolulu Consolidated Oil Company by which it sold, transferred, and conveyed all its right, title and interest in the properties to the Honolulu Company, which was to "have the sole ownership of and the right to sell or otherwise dispose of all oil and or gas and derivative products produced in, on or upon said properties", it being "the intention of the parties to this agreement that the full and complete ownership, control and operation of said properties shall vest, upon execution hereof, in Honolulu . . . and *Elbe* shall have no interest in or to any of said properties whatsoever". Honolulu agreed to pay *Elbe* $350,000 upon the execution of the agreement and, if Honolulu did not elect to abandon the purchase, the additional sums of $400,000 in each of the years 1928, 1929 and 1930, and the further sum of $450,000 in 1931. The foregoing sums totaled $2,000,000. After the time when Honolulu had been fully reimbursed from its sales of oil and gas produced from the properties for all expenditures made in the acquisition, development, and operation of the properties, *Elbe* was to receive one-third of the net profits, as defined in the contract, resulting from the continued production, if any, from the properties. *Elbe*, whose cost in the properties was less than $350,000, the amount of the down payment, reported the difference as taxable gain from a sale of the property in its returns for 1927. In its returns for 1928 and 1929, *Elbe* reported the cash receipts of $400,000 as ordinary income and claimed a deduction for depletion thereon, which allowance this Court denied.

The *Elbe* case differs from the instant case in the following respects:

1. *Elbe* sought the depletion allowance upon cash payments which were fixed sums payable without regard to production. Gulf's receipts are dependent solely upon production and therefore clearly come within the tests laid down for an economic interest in *Kirby v. Commissioner*; see page 9, *supra*.

2. The *Elbe* contract expressly stated the parties' intention to be that *Elbe* retained no interest. On the other hand, the Gulf "assignment is made subject to the following terms and conditions" which required development and sharing of the profits derived therefrom, re-assignment of the lease before its termination; that the parties understood that the contract was of limited duration is clearly shown by the concluding words "during the life of this agreement". (R. 39.)

3. *Elbe* transferred oil field equipment and flowing wells. Gulf's contract covered only oil and gas exploration rights in land yet to be proven by the taxpayer's efforts.

4. *Elbe's* provision for net profit payments did not relate to all of its transferor's net profits from operations on the properties conveyed by *Elbe*; the profit interest affected only those that might accrue after its transferee had recovered from earnings the $2,000,000 paid as the consideration for the purchase of the properties. Gulf's possibility of profit attached to every barrel of oil in place at the time of the execution of the instrument here involved.

Clearly, *Elbe's* transaction looked primarily to the sale of producing oil wells and the equipment necessary to

operate them; the predominating purpose was to obtain a large fixed sum to be received without regard to the production "as the result of a single transaction within the taxable year, as in the case of a sale of property." Cf. *Burnet v. Harmel*, 287 U. S. 103, 106; *supra*, p. 13; *infra*, p. 25. A secondary consideration was to obtain the net profit payments from the oil that might remain in place after the purchaser had earned enough to recover the whole of the purchase price. This situation is very much different than that obtaining in the present case where Gulf's only motive was to secure the exploitation of the land which was only potentially valuable and, if found productive, to have further development of the property. *Supra*, pp. 12 and 13.

In a case such as the present, where the only payments involved are dependent solely upon extraction and sale of the oil, there is no need to look to the contract and the surrounding circumstances to see if the instrument is a sale or a lease; it is enough that the recipient has an economic interest.[7] Where, however, as in the *Elbe* case depletion is claimed upon a cash payment not dependent upon production, it is necessary to determine the essential nature of the transaction as a sale or lease in order to give character to the cash as either proceeds from the sale of a capital asset or gross income from the property. The test as to such a cash payment is whether the transferor "severs his connection with production" (*Anderson v. Helvering*, 310 U. S. 404, 408; *supra*, page 8), or, as has been stated by counsel for the Commissioner, "whether the cash payment is a return of capital, or ordinary income from

[7] *Palmer v. Bender*; see p. 9, *supra*.

the property depends upon whether the recipient has a continuing interest in production" (Commissioner's brief in *Kirby v. Commissioner*, No. 56 This Term, p. 24, where the cases are summarized).

It is important to keep in mind that in the ordinary pattern of provisions for net profit payments, as in the usual stipulation for gross royalties, the possibility of profit extends to all of the oil in place at the time the right is retained or acquired. It is very apparent, therefore, that there is a distinction between such usual stipulations, and *Elbe's* provision which, if it ever accrued, would necessarily be applicable only to the oil in place at the time its vendee had already enjoyed net income from the property equal to the $2,000,000 purchase price. This distinction is, we believe, important only when a determination must be made of the character of a cash payment which is not dependent upon production but, at such time, it is very material. It was emphasized in the Commissioner's brief in the *Elbe* case (pp. 13-14) where it was asserted that there was no reasonable expectation that any profit payments would be made. As a matter of fact no net profit payments had been made in the six years which had elapsed when the case was heard by the Board of Tax Appeals (*Elbe Oil Land Development Co.*, 34 B. T. A. 333, 334) and the Board expressly refused to pass upon whether depletion would be allowable upon the net profit payments when and if any were made (p. 335). It follows, therefore, that *Elbe* had not only severed its connection with the production, but it was also highly speculative whether it would ever have any receipts arising out of the extraction of oil. Under all these circumstances

this Court was "unable to conclude that the provision for this additional payment qualified, in any way, the effect of the transaction as an absolute sale", *(Helvering v. Elbe*, 303 U. S. 372, 375.) The result, we believe, would have been no different if the provision for additional payments had been for a *gross* royalty payable only if and after the operator had reimbursed itself for its cost of acquisition. This is so because there is no essential difference between a gross royalty and one payable out of net profits[*] and, under either type of agreement, the interest in production is (under *Elbe's* facts) severed and might not revive. Thus, in *Bankers Mortgage Company v. Commissioner*, 142 F. 2d 130 (C. C. A. 5th), certiorari denied 89 L. ed. 41, depletion was denied upon cash received upon the execution of the contract because the mere fact that after thirty years there would be a possibility of accrual of a 14 10000 gross royalty to the taxpayer did not entitle the taxpayer to statutory depletion allowance before that situation materialized.

In this view, *Elbe* was not denied depletion upon the cash down payment because a provision for net profit payments is any less an economic interest than a gross royalty; or because it lacked technical title, or because it was not technically a sublessor; *Elbe* was denied the allowance for one reason only; namely, this Court could not conclude that a stipulation for payments relating only to the oil, if any, which might remain in place at a remote time in the future represented a continuing interest in production.

[*] "The lessors' economic interest in the oil is no less [than that reserved by a gross royalty] when their right is to share a net profit." *Kirby v. Commissioner, supra*, (p. 296).

In any event, there is a decided difference between the *Elbe* case where the transferor obviously sought a certain fixed sum in money as in the case of a sale of the property and the present case where Gulf's only motive was to secure income from development of the property.*

That the Tax Court (formerly the Board of Tax Appeals) has construed the *Elbe* decision as meaning that, in net profit payment cases, the practical consequences for payments of that type are to be ignored and that technical title, the form of the contract, and the legal relationship of the parties are to be determinative may be readily seen from the Tax Court's decisions. The line of demarcation drawn by the Tax Court in the earlier cases was based solely upon legal title. Thus, in *Marrs McLean*, 41 B. T. A. 565, the taxpayer assigned *all* of his title in three leases, only *three-fourths* of title in one lease (Gray lease; issue No. 2), but gave the assignee exclusive operating and management rights in the whole of this latter property. There was a provision for net profit payments from each of the four properties. The Tax Court held that depletion was allowable to the taxpayer only in respect of the lease where one-fourth of the title had not been conveyed. That the Tax Court still considers technical title and possession of an additional gross royalty determinative of the nature of a provision for net profit payments is clearly shown in *Estate of Dan A. Japhet v. Commissioner*, 3 T. C. 86, 92-93, where the Tax Court distinguishes the *Marrs McLean* case by stating:

> "In the instant case, petitioners did not assign to Humble a three-fourths interest in the sublease and

* Cf. *Burnet v. Harmel*, 287 U. S. 103, 106; *infra*, p. 25. Also see *supra*, pp. 12 and 13.

> retained for themselves an undivided one-fourth interest."

and goes on to distinguish the *Kirby* case as follows:

> "Our recent decision in *Kirby Petroleum Co.*, 2 T. C. 1258, is distinguishable. In that case the taxpayer in its assignment of the lease reserved to itself a one-sixth oil royalty, thus reserving to itself an interest in the oil in place. This fact, we held, brought the *Kirby Petroleum Co.* case within the rule followed as to the Gray lease in issue 2 in *Marrs McLean, supra.*"

However, *Kirby v. Commissioner*, *supra*, makes it clear that "the technical title to the oil in place is not important". The *Kirby* opinion also states that the reservation of royalties "would not show an economic interest in the oil not necessary for the payment of the royalties"[10] (p. 296, foonote 6) and that if "the only payment . . . made was the portion of the net income . . . it would be clear that such payment . . . would taxwise be rent or royalty paid by the lessees for the privilege of extraction". (p. 297.)

The Tax Court has also, on occasion, considered reversionary rights of importance. As pointed out by counsel

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[10] While Gulf did not retain a gross royalty for itself, it carved an overriding royalty out of the original lease interest for the benefit of a third party (R. 36). If this interest had been for Gulf's own benefit, the Tax Court clearly would have considered Gulf's net profit provision as an economic interest and not proceeds from a sale of the property. The Commissioner's brief in the *Kirby* case (pp. 21, 22) brings out forcibly that it is "untenable to hold that an interest in the operator's net profit may or may not represent a depletable interest depending upon whether the right to receive [gross] royalties has been retained".

for the Commissioner, three of such cases[11] are now pending below. In an earlier case, *Commissioner v. Felix Oil Co.*, 144 F. 2d 276 (C. C. A.-9), the taxpayer, owner of the land in fee, did not reserve a gross royalty but, like Gulf in the present case, kept only 50% of the net profits. *Felix* reserved the right to sell 50% of the oil, if it so elected, while Gulf has the right to purchase the entire production in our case. The Commissioner contended that *Felix* had made an outright sale and had no continuing interest in production. The Tax Court held, and the Circuit Court of Appeals affirmed, that *Felix* was entitled to an allowance for depletion. The chief difference between *Felix* and Gulf is that Gulf does not own the land in fee. However, it would seem that ownership of the surface of the land is quite immaterial and that Gulf has as clear a need and right to the depletion allowance.

The decisions of this Court do not seem to indicate that reversionary rights are of importance[12]. The Tax Court held in *Westley W. West, et al v. Commissioner*, 3 T. C. 431 affirmed by C. C. A.-5th in 150 F. 2d 723; certiorari denied dockets No. 667 et seq. this Term) that a reversion

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[11] Commissioner's supplemental memorandum on application for writ of certiorari in this case, page 3: *Innis v. Commissioner*, decided June 29, 1945 (1945 P-H T. C. Memo Decisions Service, par. 45246); *Williams Bar Dredging Company v. Commissioner*, decided June 30, 1945 (1945 P-H T. C. Memo Decisions Service, par. 45244); *Gracey v. Commissioner*, 5 T. C. 296, 301-303.

[12] Counsel for Commissioner has stated: "It may be observed that, generally speaking, the only practical difference between the rights of an assignor and a lessor is the reversionary interest of the latter. Since the usual oil and gas lease runs for as long as oil and gas may be produced in paying quantities, *the reversionary rights of a lessor to the oil in place are only of theoretical importance.* As is true in this case, the affirmative duties of the assignee may not be materially different from those of a lessee. Cf. *West v. Commissioner*, 150 F. 2d 723 (C. C. A.-5th), certiorari denied, January 28, 1946, Nos. 667, 668, 669 and 670, this Term". (Supplemental memorandum on application for writ of certiorari in this case, page 4, footnote 2.) (Italics supplied.)

was not an essential element in determining if the transaction was a lease or a sale. However, if they are considered as material, we wish to refer the Court to the statement of counsel for the Commissioner with respect to the Gulf contract to the effect "that the assignment here imposed certain drilling obligations on the assignee and required him to continue such operations on the land as would be required to continue the original lease in effect, if the assignee failed to fulfil his obligations, he was required to re-assign the lease to the assignor. Thus, the relationship between the assignor and the assignee was, in many respects, similar to that which exists between a lessor and lessee of an oil and gas lease".[13] The lease must be re-assigned to Gulf at least thirty days before the maturity of any obligation under the lease (R. 35), which gives Gulf a part of the term. It may be further noted that Gulf did not purport to convey the whole of the estate created by the original lease but, in addition to the provision for a share of profits, specifically excepted (a) an overriding oil royalty for the benefit of a third party (R. 36), and (b) all sulphur rights (R. 38). Thus, the instrument here had every element of a contract of sublease.

The soundness of the result reached in the *Felix* decision is certainly not open to doubt, because, as this court has said (*Kirby v. Commissioner*, *supra*, p. 297):

> "If we assume that the only payment for the privilege of oil extraction made to the taxpayer lessors by the lessees was the portion of 'net income' paid under the leases, it would be clear that such payment of 'net income' would taxwise be rent or royalty paid by the lessees for the privilege of extraction."

[13] Supplemental memorandum on application for writ of certiorari in this case, page 4.

Accordingly, since Gulf stands in the same position in every material aspect, there would seem to be no logical reason why Gulf, which is entitled to secure the profits throughout the term of the lease, should, by the effect of the decision here, be required or permitted to treat the transaction as a sale of the natural resources in place. The theory underlying the allowance for depletion is that a gradual sale is made and the allowance represents the reduction in the reserve from which the produce is taken. *U. S. v. Ludey*, 274 U. S. 295, 301. The capital gains provisions and limited surtax rates on sales of oil properties were not intended to cover deals which look to the working of the mineral deposit for income to be realized gradually over the life of the deposit and according to the actual results obtained from operations. *Burnet v. Harmel, infra; West v. Commissioner*, 150 F. 2d 723 (C. C. A. 5). Thus, in *Burnet v. Harmel*, 287 U. S. 103, 106, it was stated:

> "But notwithstanding this incidental transfer of ownership, *it is evident that the taxation of the receipts of the lessor as income does not ordinarily produce the kind of hardship aimed at by the capital gains provision of the taxing act.* Oil and gas may or may not be present in the leased premises, and may or may not be found by the lessee. If found, their abstraction from the soil is a time consuming operation and *the payments* made by the lessee to the lessor *do not normally become payable as the result of a single transaction within the taxable year, as in the case of a sale of property.*" (Italics supplied.)

The decisions below do, of course, cause the petitioner to bear a heavy burden by including Gulf's profit payments in its taxable income which admittedly petitioner

would not be required to do if it had acquired the privilege of extraction from a landowner or from an assignor who possessed a gross royalty. However, as is frequently the case, the decision cuts both ways. This is so because, if the petitioner's payments are purchase price for oil in place, the payments in Gulf's hands represent proceeds from the sale of oil in place and, no doubt, are entitled to the preferential treatment accorded capital gains. Under these circumstances, we are not only unable to understand why the taxpayer should bear a greater relative tax burden than other producers who acquired their privilege of extraction from landowners or from one who also possessed a gross royalty, but we also are unable to understand why Gulf, which enjoys 50% of the net income, should pay tax upon that 50% at capital gains rates while the taxpayer pays upon 100% of the net income at ordinary rates but enjoys only 50% of the income. Considering that Gulf's income will continue until the exhaustion of the oil deposit, that some expenses are not taken into account in computing its 50% of the profits, and that Gulf has the reversion of the oil rights, it seems clear that Gulf's interests in the oil in place are actually more extensive than those of your petitioner. Petitioner cannot retain Gulf's one-half of the net income; it derives no more benefit from Gulf's share than the operators who share net income with the landowners. The economic consequences to your petitioner are precisely the same whether or not Gulf is technically a sublessor; they would be no different if Gulf also possessed a royalty payable out of gross production or the fee interest in the land.

This Court has never held that receipts which depend solely upon the production of oil represent proceeds from the sale of the property; to the contrary, it has always held such receipts are gross income from the property.

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## CONCLUSION.

In view of the foregoing, the judgments of the Tax Court and the Circuit Court of Appeals should be reversed.

Respectfully submitted,

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## APPENDIX.

### Revenue Act of 1934.

SEC. 22. GROSS INCOME.

(a) General Definition. "Gross income" includes gains, profits, and income derived from salaries, wages or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(26 U. S. C. A. 669, 1940 Edition.)

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) Expenses. All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity

(26 U. S. C. A. 671, 1940 Edition.)

(m) Depletion. In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance

for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * * In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * *

(26 U. S. C. A. 673, 1940 Edition.)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

(b) Basis for Depletion—

(3) Percentage depletion for oil and gas wells. In the case of oil and gas wells the allowance for depletion under section 23(m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23(m) be less than it would be if computed without reference to this paragraph.

(26 U. S. C. A. 702, 1940 Edition.)

**Revenue Act of 1936.**

The provisions of Sections 22(a), 23(a), 23(m) and 114(b)(3) of the Revenue Act of 1936 are identical with the corresponding sections of the Revenue Act of 1934.